No. 14852

IN THE

United States Court of Appeals

FOR THE NINTH CIRCUIT

C. A. SWANSON & SONS POULTRY COMPANY,

Appellant,

vs.

WILLIAM A. WYLIE, Trustee in Bankruptcy for the Manuel Delatorre dba R & M Egg Farms, Bankrupt,

Appellee.

APPELLANT'S OPENING BRIEF.

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Statement of Pleading.

The within appeal is from a judgment in the District Court for the Southern District of California, Central Division, in an action under Section 60 (b) of the Bankruptcy Act brought by the Trustee in Bankruptcy to recover $12,267.05 paid by the bankrupt to the appealing creditor within four months of the adjudication of bankruptcy; the Trustee alleging that at the time of the payments the bankrupt was insolvent, and that the appellant had reasonable cause to believe that the insolvency existed. [Complaint, p. 3, Record on Appeal.]

The answer admits the receipt of the payments, but denies that there was reasonable cause to believe that insolvency existed at the time the said payments were received. An affirmative defense of the extension of further credit was included in the answer, but upon the trial

it was shown to be a bookkeeping re-entry of an older item, rather than a new credit, and there was no issue on that point. [Answer, p. 6, Record on Appeal.]

At the trial the issues were narrowed down to the question of whether or not appellant knew or had reasonable cause to believe, at the time of receiving the payments complained of in this action, that the bankrupt was insolvent; and whether or not the said creditor knew, or had reasonable cause to believe, that any such payments would constitute a preference as against other creditors.

It is the contention of appellant that the evidence failed to prove that appellant creditor either had knowledge, or had reasonable cause to believe, that the bankrupt was insolvent at the time the payments were made.

Statement of the Case.

The undisputed evidence shows that the appellant is a wholesale egg distributor from whom the bankrupt had been buying merchandise for some two years prior to the adjudication of bankruptcy. That bankrupt had been fairly prompt in his payment until his partner died about March 29, 1953, at which time his checks commenced to return from the bank. Although the liabilities at that time exceeded the assets, a fact known to the surviving partner and his accountant, this was withheld from the public in general, and the appellant creditor in particular, and by a series of devious explanations for the returned checks and false information furnished to Dun & Bradstreet and other credit information agencies, the appellant and the other creditors of the bankrupt were lulled into believing that the business was sound but short of cash. As the checks were returned by the bank they were liquidated by the bankrupt.

During the middle of June of that year the appellant's credit manager became concerned over the large unpaid balance, in view of the returned checks, and in company with appellant's auditor visited the bankrupt's place of business, requested and received a chattel mortgage covering the fixtures and equipment, and informed the bankrupt that until his outstanding balance was reduced, his purchases would have to be on a cash basis. They glanced over the bankrupt's books and came away with the conclusion that he was financially sound, that "his net worth if he had to liquidate would be $14,000.00 or $15,000.00 which convinced us that his mortgage was good." [P. 90, Transcript.] This chattel mortgage was never recorded, and no claim therefor was presented in bankruptcy. On July 3rd the bankrupt reported to Dun & Bradstreet that he was doing a business of $250,000 a year and had a net worth of some $16,000.00. [See Tr. p. 57, and Deft. Ex. A, Tr. p. 75.] The instant action is to recover from the appellant the seven payments made by the bankrupt to the appellant within the four-month period, but before appellant had any actual knowledge of the insolvency of the bankrupt.

The only evidence with respect to the claim that appellant had reasonable cause to believe the debtor insolvent consisted of the returned checks. The Trustee in Bankruptcy contends that this is sufficient to have charged appellant with knowledge of the insolvency, or at least to have put the appellant creditor on notice. Appellant, on the other hand, contends that the slowness in pay was explained by a shortage of cash caused by the necessity of paying out the interest of the deceased partner in the business, and its inquiries from its competitors and the various credit information agencies convinced it that the bankrupt had a net worth of about $15,000.00.

ARGUMENT.

In Order That a Payment by a Bankrupt Should Operate as a Preference, It Must Be Shown That the Bankrupt Was Insolvent, That the Creditor Had Reasonable Cause to Believe the Payment Was Intended as a Preference, and That a Preference Actually Resulted.

While subsequent events proved that the bankrupt was insolvent at the time the payments in question were made, it was definitely not shown that the appellant had cause to believe that the payments would result in a preference, nor was it proven that a preference actually resulted.

The bankrupt testified that his credit with appellant was allowed to continue until after he gave the chattel mortgage, which was dated June 12, 1953. [Tr. pp. 41, 48. See also Pltf. Ex. 1.] The record clearly shows that at least three of the payments—totalling $6,120.26—were received prior to that date, namely, a payment of $2,542.19 on June 5, one of $1,632.00 received on May 29th but clearing the bank on June 10th, and a third one of $1,945.35 received by Swanson's on May 22nd, but not cleared through the bank until June 22nd. [Tr. pp. 26, 34.] The testimony of the bankrupt was that he withheld knowledge of his insolvent condition from appellant and his other creditors in an effort to survive his financial crisis, and even went so far as to give misleading and false information to Dun & Bradstreet in furtherance of this effort. No evidence was presented by the Trustee to show any knowledge on the part of the appellant, or a reasonable cause to believe that the debtor was insolvent, except an attempt to create an inference from the slowness in paying bills, and the returning of checks.

Neither the fact that a debtor's accounts are past due, nor the fact alone of his financial embarrassment, is sufficient to impeach the good faith of a creditor in taking security so as to render the same voidable as a preference under the Bankruptcy Act, where there were circumstances which tended to explain such embarrassment upon grounds other than insolvency, *J. W. Butler Paper Co. v. Goembel*, 143 Fed. 295; *Arthur v. Harrington,* 211 Fed. 215. Here the debtor's statements to the creditors, and the report of the generally reliable credit agencies, was to the effect that the debtor was solvent but was experiencing difficulties in paying on time by reason of having to settle the claims of his deceased partner's estate.

In the case of *In re Wynne,* Federal Case No. 18,117, Chase 227, 9 Am. Law. Reg. NS 627, the court held that knowledge that a party is embarrassed in carrying out his business for want of means is not sufficient to fix on the grantee in a trust deed knowledge of his insolvency, if he fully believed that his property is more than sufficient to pay all his debts. Here appellant's credit manager and auditor in June prior to the adjudication glanced through the debtor's books and reached the conclusion that he had a net worth, even on liquidation, of about $15,000.00. [Tr. p. 101.]

At no time during the trial was it brought out that appellant's receipt of these payments resulted in a preference, except for the hearsay statement and conclusion of the bankrupt, in response to a question by counsel for the Trustee, that during the period in question "not all" of his creditors received the same percentage of payments on their accounts during that time. [Tr. p. 102.]

The Burden Is on the Party Seeking to Set Aside the Transfer to Show That All These Conditions Existed at the Time the Transfer Was Made.

The bankrupt's insolvency and the creditor's reasonable cause to believe that a preference would result, must be proved as facts, *Chicago Car Equipment Co. v. Buell,* 211 Fed. 638. It is not enough to raise a question in the mind of the Court, but the burden is on the Trustee to prove it in the same manner that is required of any other factual issue. In the foregoing paragraphs we have shown that not only did the Trustee fail to show a knowledge or reasonable cause to believe on the part of appellant, but the evidence clearly points the other way. The bankrupt himself testified that he received credit, albeit on shorter terms, after several of the payments and up to the signing of the chattel mortgage on June 12. Mr. Cross, credit manager of Swanson's, testified that they had no inkling of insolvency until other creditors late in July took possession of the contents of the bankrupt's cash register. Both he and the bankrupt testified that throughout June and part of July the bankrupt was buying on credit from other suppliers and was reported to be doing a good business. Mr. Cross further testified that he was in touch with his competitors and received favorable reports as to the bankrupt's progress. The July 3rd report of Dun & Bradstreet indicated that the bankrupt's volume of business had increased and was profitable, that he had a net worth of $16,640.00, and that he was past due in payment to only one creditor, presumably appellant.

The Evidence Presented to the Trial Court Was Insufficient to Warrant a Finding That a Preference Was Created in Favor of the Appellant.

As above stated, appellant introduced direct testimony, which was uncontradicted, that it had no knowledge of bankrupt's insolvency at the time it received the various payments. If it had no knowledge of the insolvency, it follows as a matter of course that it had no knowledge that the payments it was receiving would constitute a preference as against other creditors. To the contrary, it adopted this attitude in effect: "We have overextended ourselves on credit to you. Until you cut down the unpaid balance we will have to limit your credit and suggest that you buy elsewhere in the meantime." In the meantime they endeavored to reduce the outstanding balance. The trial judge, in overruling an objection of the Trustee [Tr. p. 65], took cognizance of the fact that it was material for the appellant to know that the bankrupt stayed in business and continued to get credit from others, in determining whether or not the appellant had reasonable cause to believe the bankrupt to be insolvent.

A bankrupt's inability to make payments on demand, while continuing business, does not imply insolvency, as regards recovery of preference, *Miceli v. Morgano,* 36 F. 2d 507; *McDougal v. Central Union, etc.,* 110 F. 2d 939; *In re Venie,* 80 Fed. Supp. 247. In the *McDougal v. Central Union* case, *supra,* the court said, "Although the bankrupt may act in bad faith and with a fraudulent purpose in mind, yet if the transferee is free of fraud and acts in good faith, and gives a present fair consideration in ex-

change for the transfer of property, the transaction cannot be set aside. *Payment of an antecedent debt is a fair consideration."* (Italics ours.) There is no contention on the part of the Trustee that these payments were made for any other purpose than to reduce the antecedent debt of the bankrupt. As a matter of fact, the record discloses that even after the payment of the more than $12,000.00 there still remained due to the appellant a balance of some $5,000.00. The courts have gone so far as to say that where a bankrupt's transferee is merely a creditor accepting payment of an honest debt without knowledge that a preference will result or that the transferor was actuated by a purpose other than to pay the debt, the transaction cannot be set aside as a fraudulent conveyance, *though the debtor intended to defraud other creditors. Irving Trust Co. v. Chase Natl. Bank,* 65 F. 2d 409.

An examination of the testimony taken during the trial, all of which is printed in the transcript, indicates that the only possible basis for the finding that appellant had reasonable cause to believe the debtor insolvent was the mere fact that the checks were being returned by the bank. Counsel for appellant humbly begs to be excused for his constant return to this statement, but this conclusion is inevitable from an examination of any side of the case. The trial judge, in taking the case under submission, himself expressed doubt that evidence of "checks bouncing" would of itself support a finding that there was reasonable cause to believe that the debtor was insolvent. [Tr. p. 105.] Theoretically it is possible that he decided that the asking for and obtaining of a chattel mortgage constituted sufficient grounds for a suspicion in the minds of appellant's agents, yet it remains undisputed that appellant kept in constant touch with credit agencies

and with its competitors, and found no immediate cause for alarm. *A mere apprehension* on the part of the creditor, of the insolvency of his debtor, who subsequently becomes bankrupt is not equivalent to "good cause" to believe that insolvency of the debtor exists so as to permit the trustee to set aside a pledge by the debtor to secure the creditor as a preference, *Harrison v. Merchants Natl. Bank of Ft. Smith, Ark.,* 124 F. 2d 871; *Sec. First Natl. Bank v. Quittner,* 176 F. 2d 997.

We now come to the question of whether the appellant had reasonable cause to believe that a preference would result by the payments made to it by the bankrupt. The burden was upon the trustee to show this affirmatively, *Chicago Car Equipment Co. v. Buell, supra.* Mere incidental injury to bankrupt's creditors, resulting from a preference, does not make it void as a fraudulent conveyance, since there must be intent unlawfully to hinder creditors, *Irving Trust Co. v. Chase National Bank, supra.* If appellant, at the time it received payments on account, had no reason to believe that the debt would not be paid, the payments were not voidable, *Latrobe v. J. H. Cross Co.,* 29 F. 2d 210. Following out this doctrine we find that appellant believed the bankrupt to be solvent, that his volume of business was increasing, and that he was operating at a profit.

Where a debtor made a payment of $2,500.00 on account to the creditor within four months of the date the debtor voluntarily filed bankruptcy, but before the creditor had knowledge of the debtor's insolvency, the debtor's trustee in bankruptcy could not subsequently recover the payment as an illegal preference, *Robie v. Myers Equipment Co.,* 114 Fed. Supp. 177.

Finally, where enough assets remain, after the transfer to one creditor, to give other creditors in the same class as great or a greater percentage of their claims, no voidable preference results, *Haas v. Sachs,* 68 F. 2d 623. This case is cited in connection with the testimony of the bankrupt at the trial herein that the other creditors were receiving similar payments at the same time. [Tr. p. 102.]

Conclusion.

From all of the foregoing, it is respectfully urged by appellant that there was no basis upon which the trial court could find that the appellant had reasonable cause to believe that the bankrupt was insolvent [Finding VI, Tr. p. 16], and, there having been no direct testimony on the subject, it could not have been found that the said payments enabled the appellant to obtain a greater percentage of payment on its debt than other creditors of the same class. [Finding VII, same page.]

Appellant, therefore, prays that the judgment of the lower court be reversed.

Respectfully submitted,

NORMAN A. OBRAND,

Attorney for Appellant.